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There is but one means available to improve the material conditions of mankind: to accelerate the growth of capital as against the growth in population. The greater the amount of capital invested per head of the worker, the more and the better goods can be produced and consumed. This is what capitalism, the much abused profit system, has brought about and brings about daily anew. Yet most present-day governments and political parties are eager to destroy this system.

— Ludwig von Mises, *The Anti-Capitalistic Mentality*, 1956

A MISMANAGED RECOVERY

In 2005, real disposable incomes of private households in the United States rose 1.3%, their lowest rate in the postwar period, as against real GDP growth of 3.5%. By the latter measure, the U.S. economy is doing fine; by the former, people are doing miserably. Which of the two measures is more relevant?

Purchasing power from earned income is the great deficiency of this economic recovery. But instead of catching up, it falls still more behind. Bolstered by tax cuts, real disposable personal income grew by 3.4% in 2004. Conventional wisdom in America holds that consumption stimulates capital investment. The ugly truth is that excessive consumption has the opposite effect of crowding out investment and with it the economy's capacity of income creation.

Some recent U.S. economic data have been surprisingly strong. They should be taken with a large dose of salt because of the problematic huge seasonal adjustment. Retail sales in January were in reality down $90 billion, or more than 20%, but seasonal adjustment turned this into an increase of 2.3%, by far the steepest increase in years.

In hindsight, the National Bureau of Economic Research determined that the U.S. economy went through a recession from March–November 2001. This adds up to barely eight months. For the year as a whole, real GDP increased, though slightly, by 0.8%.

For historical perspective: Past postwar recessions have on average lasted a full year, with a decline in real GDP of 2%. By far the worst recession, actually, occurred in the wake of the first oil shock in the 1970s, with a decline in real GDP by 4.1%.

Considering that the Greenspan Fed managed this mildest postwar recession even against the backdrop of the bursting equity bubble, the hardly visible recession of 2001 certainly appears to many as one of Greenspan's greatest masterpieces in monetary policy. Also, it seems to perfectly vindicate his earlier observations that it is better to deal with the aftermath of a bubble than to prick it pre-emptively.

The enthusiasm over the shallow 2001 recession has always struck us as extremely shortsighted and superficial. Recessions cannot be judged in isolation. They have a highly positive function in the cyclical process in that businesses and consumers, under the pressure of tight money, unwind their borrowing-and-spending excesses during the boom. In the same vein, the tight money created pent-up demand in business investment, housing and durable consumer goods that propelled the following recovery.

In a way, these were "managed" recessions, managed by the central bank's monetary tightening. Thanks to these enforced adjustments, recessions regularly laid the foundation for vigorous recoveries to follow.

Notoriously, in all industrial countries over the whole postwar period, recoveries from recession have proved

the "golden" phase of the business cycle. As soon as central banks removed their brakes, the economies regularly delivered their best in every single economic respect—in growth of employment, investment, income and profits.

Nothing of this kind has happened in the 2001 recession and the following years. Instead, the U.S. economy "enjoyed" the loosest monetary policy and the greatest credit deluge on record, which since then has drastically worsened the earlier boom-related excesses. Mindful of these historical facts, recessions must be judged in the context of the ensuing recoveries.

The U.S. economy's recovery from its cyclical low in November 2001 is the first radical exception from this rule. There never was any credit slowdown. Yet taking the shallow recession and following recovery together, U.S. economic growth has been far below the norms of past cycles.

In past recessions, as mentioned, the U.S. economy lost 2% of GDP, on average. But subsequent vigorous upturns richly offset this loss. Real GDP growth during the first two years of recovery after a recession has averaged 10.2%. Deducting the prior GDP loss of 2%, the average net gain in real GDP over the three years was a stellar 8.2%.

And what was the U.S. economy's net gain in real GDP during 2001–03 from its shallowest recession? In short, an anemic 5.1%. Real GDP actually increased during the recession year by 0.8%. But the first two recovery years brought only 4.3% in real GDP growth. Compared with the average of all past cycles, this represents a shortfall of 38%. You see how grossly misplaced this common boast of the shallowest recession is.

The general perception, of course, is that the U.S. economy has been performing exceedingly well during the past few years. That is true, but only in comparison to the economies of Europe and Japan, which have been growing exceedingly slowly. Usually, such a comparison is perfectly legitimate; in this case, however, it plainly serves to hide how badly the U.S. economy has done compared with its own past.

Next, we have to point out that different gauges offer very different pictures of the U.S. economy's performance during this time. "Real GDP" happens to be traditionally the most popular measure of performance. Other gauges more relevant to people, in particular employment and income growth, show a diametrically worse picture. Their sluggishness is such that it raises the question whether this recovery really deserves this description.

The following table compares the growth rates of the most important economic aggregates from 2002–03 with the corresponding average growth rates during the first two recovery years after recession of prior cycles.

Rates of Growth During the First 2 Years of Recovery From Recession, in %

	Postwar average	2002–03
Real GDP	10.2	4.3
Personal consumption	9.9	5.2
Nonresidential structures	4.8	-21.3
Nonresidential equipment	21.4	3.6
Residential investment	36.7	13.2
Net exports	0	-30.6
Industrial production	17.9	2.2
Private employment	6.6	-1.7
Real disposable income	9.0	5.5
Real wage and salary income	9.0	4.6

Source for first column: Federal Reserve, Quarterly Review, Summer 1993;
Source for second column: Bureau of Economic Analysis

It is a difference like day and night between the two columns. Strikingly, real GDP growth stands out as the best performer during 2002–03. As we have explained many times, U.S. statisticians have been highly inventive

in getting the lowest possible inflation rate. Just 1–1.5 percentage points lower makes all the difference for GDP and productivity growth.

Manifestly, the U.S. economy's recovery had an extremely bad start. But lack of aggregate strength compared with past postwar cycles is only part of the problem. From a long-term perspective, the greatest and also most important differences are in the unusual pattern of economic recovery.

Under Mr. Greenspan's stewardship, unparalleled credit expansion has engendered profound structural dislocations in the real economy, while assuring booming asset markets. The question to investigate is not why the economy was so strong, but why it was so weak against the backdrop of such prodigious credit expansion and tax cuts.

Looking for outstanding negative influences, we identify three:* first*, weak business fixed investment;* second*, the huge and soaring trade deficit; and* third*, extremely poor employment growth, with big losses in manufacturing.

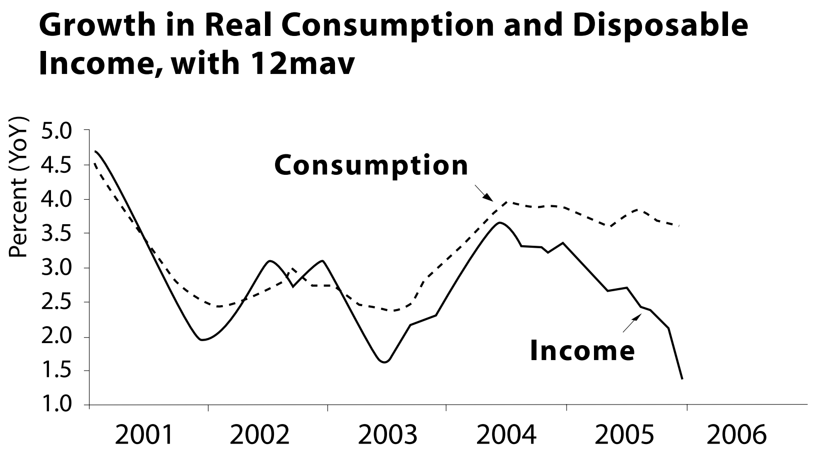
Essentially, the depressive effects of the first two factors had calamitous consequences particularly for industrial production and associated employment and income generation. Growth of industrial production has been a fraction of what it has been in past recoveries.

The outright horror story of this recovery is the grossly lacking employment and income growth. On average, real disposable incomes have increased 9% in the two years immediately following a recession. After the 1990–91 recession, they rose 4.4%. This time, during 2002–03, they have been up 5.5%, having fared at least somewhat better than in the early 1990s.

But there is a snag. This time, income growth was heavily bolstered by unparalleled tax cuts. According to calculations of the Economic Policy Institute in Washington, they amounted to $870 billion altogether, of which the far greatest part went to the consumer. This compares with real disposable personal income growth by $781.2 billion, or 10.6%, during 2002–05.

In 2005, the first year without tax cuts, the growth rate of real disposable personal incomes promptly plunged to 1.37%, from 3.4% the year before. In 2000, the last boom year, real disposable income of private households grew by 4.8%.

The fact to see is that the U.S. economy's capacity to create real disposable incomes has virtually collapsed. Also importantly, hiring has been concentrated at the very low end of job pay—in industries like restaurants, leisure, employment agencies, health care and social services.



Source: Thomson Financial Datastream

A few months ago, Paul Krugman wailed in an article in *The New York Times, "American families do not care about GDP. They care about whether jobs are available, how much those jobs pay and how their pay compares with the cost of living…This is an economic expansion that has not trickled down."*

What matters for people is, of course, employment and income, not GDP growth reflecting growth of spending with borrowed money. Since every dollar spent becomes a dollar earned by somebody, it makes sense to regard GDP growth as a proxy for income growth. But in the past few years in the United States, spending and income numbers have fallen out of line as never before. The only reasonable explanation is greater statistical spin in the GDP numbers than in the income numbers.

THE FOURTH-QUARTER SHOCK

Reading that the Bureau of Economic Analysis reported for the fourth quarter of 2005 a growth rate of only 1.1% for real GDP, we were shocked. According to available figures of weak consumer expenditures in October and November, nothing else could be expected, but with full trust in the ingenuity of America's official statisticians to hide any ugly truth, we could not believe to see this truly reported.

Minutes after this news had come out, bullish spin ran amok in the media. Everybody agreed that this simply could not be true or that it must be a statistical aberration sure to be revised upwards. Millions of Americans found in their e-mail a note from none other than Treasury Secretary John Snow:

> *The advanced estimate of fourth-quarter 2005 GDP released this morning is inconsistent with the underlying strength of the U.S. economy.*
>
> *I would not read too much into today's numbers. They are somewhat anomalous, reflecting some special factors. They are not consistent with other data on the U.S. economy, which paint a picture of good growth… The American economy is on a good course and I am very confident. I am optimistic about the first quarter and the year ahead and am confident that we will see strong growth for the year...*
>
> *We will look forward to revisions of the preliminary estimates in the coming months. Economic fundamentals point to continued strong economic performance in the United States in 2006. The U.S. economy is performing well.*

Frankly speaking, we feel sorry for the U.S. government's statisticians. Mr. Snow's letter only confirms what we have always suspected. They are under tremendous pressure to produce good-looking numbers.

It would have been interesting if Mr. Snow had spelled out the "special factors" in his mind responsible for the quarter's unusual weakness. The single biggest special factor was certainly the change in inventories, accounting for 125% of the reported real GDP growth. Without this big addition in inventories, GDP growth, measured in final sales, would have been negative 0.3%.

Shocking also was the trade figure. At annual rate, the deficit rose from $617.5 billion to $650.3 billion, subtracting a whopping $32.8 billion, or 1.18 percentage points, from the reported growth in domestic spending. Two of the largest monthly trade deficits occurred in October and November.

A temporary aberration was certainly the decline in government spending, subtracting 0.45 percentage points from GDP growth, after adding 0.54 percentage points in the prior quarter.

Given the virtual certainty of slowdowns in the housing bubble and consumer spending, the one crucial question about the U.S. economy at this juncture is whether business fixed investment is taking over as the economy's engine of growth. The consensus takes it for granted, pointing to excellent profits and balance sheets.

Business fixed investment has recovered from its low in early 2003. Even with the big tax incentives, however, this recovery has been painfully slow. In real terms, it is up barely 4% for the whole nonfinancial sector since 2000. After a modest rise during 2004, growth rates are down again.

PROFIT ILLUSIONS

This optimism about business investment has its main cause in the perception that U.S. corporations are in excellent shape, both in terms of profits and liquidity. There has, indeed, been a sharp rebound of profits from the lows in recession year 2001. But what else was to be expected? Profits fall overproportionately when the economy slows and rise overproportionately when the economy recovers. That is the cyclical part of the profit movements.

To make a reasonable assessment, the cyclical profit upturn has to be projected against the long-term trend. In this respect, the most sensible signpost in the U.S. case is the year 1997. It is the year in which the profits boom of the late 1990s peaked.

Since then, nonfinancial profits were up 5.1% in 2004. But this modest rise covers seven years, during which

nominal GDP has risen 41%. Measuring profits in relation to GDP, one realizes that today's profit margins are in the aggregate far below their levels in 1997. As a share of GDP, they have actually fallen from 6.1% in 1997 to 4.3% in 2004.

So much for aggregate profits. But next, it is important to see that there has been a tremendous change in their composition between sectors. The big profit gains are where the housing bubble rules and, generally, in services, all of them sheltered from foreign competitions and flourishing from the Fed's credit excesses. Manufacturing is the solitary big loser.

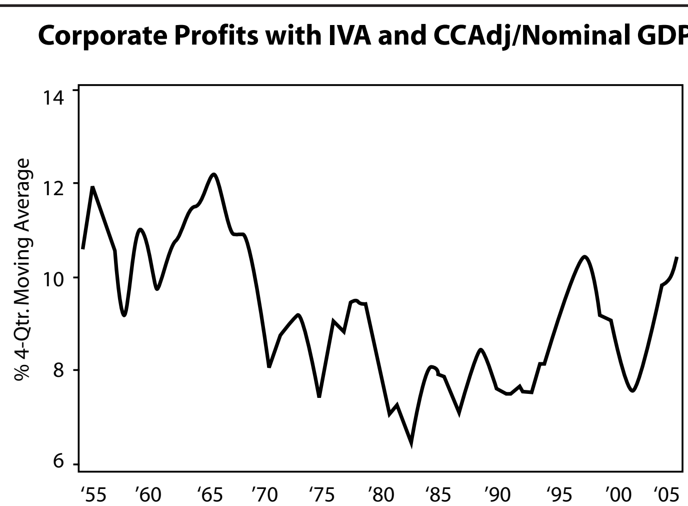
Changes in Corporate Profits by Industry
(Billions of Dollars)

	1997	2004	Change in %
Nonfinancial	508.4	534.2	5.1
Manufacturing	209.0	118.9	-43.1
Durable goods	103.1	34.8	-66.2
Nondurable goods	105.9	84.0	-20.7
Wholesale Trade	47.6	63.5	33.4
Retail Trade	64.2	90.0	40.2
Other	103.4	224.3	116.9
Rest of the World	110.9	184.9	66.7

Source: Bureau of Economic analysis, Table 6.16C

Strikingly, one sector, rubricated under "Other," puts all other sectors in the shade with the steepness of its rise in profits. A footnote reveals a checkered list of branches: construction, real estate and rental and leasing, administrative and waste management services, educational services, health care and social assistance, entertainment, recreation, accommodation and food services, except government.

These branches, then, are the U.S. economy's great profit-makers in recent years. We presume that the housing bubble, with related branches, has played the single most important role in boosting the profits in this sector. Looking at the profit structure, one realizes that this economy is in serious trouble.



Source: The Northern Trust Company

In 2004, this obscure "Other" sector accounted for 42% of total U.S. nonfinancial profits, compared with 20% in 1997. This big gain had its virtually precise counterpart in the reverse movement of manufacturing profits. Their share of total profits fell from 41% in 1997 to 22% in 2004.

Not surprisingly, the drastic divergence in the profit performance is the virtual mirror image of the drastic changes in the composition of national output. This exorbitant shift in the U.S. economy's pattern of output, employment and profits over the past few years must be the starting point for any reasonable assessment of future prospects.

INFLATION CHANGED ITS COURSE

But what has caused this tremendous and detrimental structural shift? Inherently, the outgrowth of the atrocious asset and credit bubbles, which the Greenspan Fed has systematically engineered. It is intrinsically in the nature of such bubbles to fuel highly lopsided demand. In the United States, it is consumption; in Japan, it was capital investment.

In the past, such credit excesses would have driven up U.S. goods inflation rates, thus inducing the Fed to tighten its reins. This time, the dollars from the borrowing-and-spending binge took their way overwhelmingly into two entirely other directions. The big recipients, creating the trade deficit, were foreign producers possessing idle production capacities and U.S. asset markets, enjoying inflating asset prices. Few people in the United States, least of all apparently Mr. Greenspan, understand the two features as inflation.

A supply deluge of low-cost manufactured goods from abroad, as reflected in the huge and soaring U.S. trade deficit, has unquestionably played a far greater role in keeping a lid on U.S. consumer prices than Mr. Greenspan's (extremely loose) monetary policy. But this deficit involves a heavy economic cost. It implies that in 2005, domestic spending in the amount of $726 billion bypassed domestic producers in favor of foreign producers.

If spent in the United States, this amount would have added to spending and employment in U.S. manufacturing. Instead, this spending ended up with Asian producers. That is the immediate effect. In secondary effects, such a growing diversion of domestic demand essentially depresses manufacturing capital investment, thus giving the trade deficit a cumulative trend.

Now, to prevent this major drag of the trade deficit from slowing economic growth, the Fed has stuck to its policy of "limitless" credit expansion, supposedly justified by the low inflation rates. But the alternative spending created in this way is of an entirely different kind than that lost to manufacturing. The new demand is generally for services. Rapidly declining high-paying manufacturing employment is replaced by rising service employment, most of it of low pay.

CAPITAL FORMATION IN ECLIPSE

A widespread view holds that excellent corporate balance sheets and profits will boost business investment spending, in this way assuring sustained U.S. economic growth.

As explained in some detail, this perception is, in the first place, dead wrong. The high profits are in the housing bubble and the service sectors, which do very little capital investment. Manufacturing, the sector with the highest rate of capital investment, is facing a profit disaster.

The U.S. economy's downturn in 2001–03 was unique with its unusually sharp slump in business fixed investment. But there was a second crucial difference to past experience. All past investment slumps had occurred under the pressure of tight money and rising interest rates. The investment slump in 2001–02 was the first to occur against the backdrop of sliding interest rates and the most radical monetary easing in history. What better proof could there be that this decline is not just cyclical, but structural?

Business fixed investment has been recovering, yes. Yet it has badly lagged the growth of all other relevant GDP components, because the policies to revive the economy have operated exclusively through the asset bubbles and consumer credit. Though even heavily stimulated by tax incentives, business fixed investment in 2005 was up only 4.5% from its level in 2000. For perspective: GDP +13.4%; consumer spending +16.6%, of which spending on durable goods +31.8%; residential building +34.7%; government spending +15.3%; exports +8.8%; and imports +23.7%.

Pondering the possibility of an acceleration in business capital investment, we must first point out that there is more weakness here than most people think. A proper assessment requires a distinction between gross and net investment. In industrialized countries with a large capital stock, a lot of investment is needed just to offset the scrappage of older equipment, as reflected in high and sharply rising depreciations.

Only investment above the amount of depreciations serves to increase the existing capital stock. Gross investment tends to improve the quality of the capital stock, but may overstate total capital accumulation. In the United States, the pickup in investment over the past few years has been exclusively correlated to rising depreciations, after a drastic shift in business investment over the past 10–20 years toward short-lived capital goods of the new, high-tech type.

Low savings and capital investment rates have a long tradition in the United States. The difference today is that they are lower than ever. In his book, *Capital in the American Economy*, published in 1961, professor Simon Kuznets, one of America's greatest economists, already wrote with a tone of amazement:

> *The main question is why the ultimate consumers in our rapidly growing economy have managed to save only a small proportion of their income (at best slightly over 10%), and a proportion which, on a net basis, declined rather than rose, despite rising real income per capita.*
>
> *This country's economy is geared to rising consumption, and our institutions and pattern of social behavior encourage higher consumption per capita.*

Kuznets' book is the standard on capital formation in the United States, covering both history and theory. America went into the Great Depression, by the way, with a saving rate of 4.9%.

What is happening to the U.S. economy's capital stock in the nonfinancial sector if we subtract the depreciations from gross investment spending? The Bureau of Economic Analysis is so kind as to publish the net capital investments on a regular basis, though with a delay of a full year.

According to these official numbers, gross real fixed investment of the nonfinancial sector decreased from \$1,232.1 billion to \$1,186.7 billion between 2000–04. In between, there was a low of \$1,071.5 billion in 2002.

But as depreciations have risen faster than gross investment, net investments — that is, the additions to the capital stock — have plummeted from \$404.8 billion to \$210.2 billion. Given the high rate of short-lived investments, it now takes \$8.70 of gross capital investment to provide \$1 of net capital formation.

It is interesting to compare this recent poor development of capital spending with its development during the recovery from the 1990 recession, until then America's weakest postwar recovery. In that year, net business fixed investment was down to \$90 billion. Until 1995, it was up to \$195.3 billion, and until 2000, to \$404.8 billion.

This pattern of soaring business gross and net investment had until then been typical of all postwar recoveries, with one exception, and that was, though hard to believe, the recovery in the 1980s under Reaganomics. While sailing under the glorious trademark of supply-side economics, it ravaged the U.S. economy's supply side — in other words, the economy's capital formation — as never before. Those who warned that the soaring budget deficits would crowd out investment proved perfectly right. Presently, investment is crowded out by the consumer borrowing-and-spending binge.

SAVING MATTERS CRUCIALLY

In his book, Kuznets addresses another question of greatest relevance today. It is whether saving matters for capital formation and economic growth. He answers with a resounding yes. Verbatim:

> *The discussion… elaborates our view that the explanation of the levels and trends in capital formation in this country is to be sought in the saving process — in the factors that govern the supply of savings, rather than the demand for capital goods… The basic importance of the saving process tempts one to argue that it was the supply of savings that limited capital formation.*

Then he poses the question: *"But could not credit creation or money inflation be used to force diversion of larger proportions to capital users?"* His answer is categorically in the negative, arguing that resulting rising prices would probably reduce voluntary saving. Yet conceding that it might be possible in the short run, he states categorically that this is definitely impossible in the long run. Verbatim again: *"It is the long-run factors on the supply-of-savings side that limit the potential levels and affect the potential trends of the capital formation proportions, even given the mechanism of credit creation and money-issue financing."*

Apparently, very many economists today are entirely unaware that saving fulfills two entirely different functions.

One is to finance investment, the one role of which most economists think. But that is not the key role. The decisive macroeconomic function of saving is that it releases physical resources for the production of capital goods.

This perception of saving as abstention from consumption used to be the central idea about saving in all languages and for all schools of economic thought, by the way, including that of J.M. Keynes. In his *Treatise on Money*, he defined saving precisely as follows: *"Saving is the act of the individual consumer and consists in the negative act of refraining from spending the whole of his current income on consumption."*

More precise is perhaps the following definition of savings in Gottfried Haberler's book *Prosperity and Depression*, published in 1937: *"Looking at the problem broadly, it is clear that the social function of saving is to release resources from the production of goods for immediate consumption for the production of producers' goods."*

Perhaps the very best explanation of the macroeconomic essence of saving we know of is from Roger W. Ferguson Jr., vice chairman of the Board of Governors of the Federal Reserve (Speech of Oct. 6, 2004, to the National Bankers Association):

> *The act of saving is essentially about the allocation of an economy's resources. Some sector of the economy must be willing to consume less than its current income to free resources for the purchase of capital. Intuitively, we often think of saving in financial terms… But underlying all these financial transactions is the reallocation of resources away from the immediate consumption of goods and services and toward the purchase of capital goods — goods that are not consumed directly, but are instead used to produce future goods and services for consumption.*

His further remark that, by definition, a trade deficit reflects an excess of domestic investment over domestic savings is a pretty phony description of the situation in the united States, given negative savings. What really has happened is that both net savings and investment have collapsed, but net savings somewhat faster than net investment.

THE ESSENCE OF SAVING

Somebody in the Fed obviously knows. To emphasize: Saving, as understood in macroeconomics for more than two centuries, makes available the physical inputs — labor, commodities and any other material — that are required to produce plant and equipment. Intrinsically, this occurs exclusively through saving from current income, inherently reflecting current production. This is the single vital point to recognize about saving.

Manifestly, this perception has nothing in common with that prevailing today in the Federal Reserve and on Wall Street. To the outside, Mr. Ferguson is the lonely exception. Confronted with the collapse of available savings, but being both unable and unwilling to do anything against it, policymakers and the economic consensus simply emphasize other definitions that suit their purposes.

In its Sept. 24 issue of the *Survey of Current Business*, the Commerce Department's Bureau of Economic Analysis published an article, "Alternative Measures of Personal Saving." It argued that saving as reported in the National Income and Product Accounts (NIPA) is from income arising from current production, excluding capital gains from rising asset prices. While admitting that this concept is "best suited to answer questions about the domestic sources of funding for U.S. investment needs," the article identifies four alternative measures of saving, also taking account of wealth creation through rising asset prices.

Of course, this official article precisely tried to delude people about the savings disaster. Given the macroeconomic function of saving to release both financial and real resources for capital investment, there is but one solitary proper measure: saving out of current income arising from current production.

Preposterously, the new way of identifying saving also with rising asset prices has precisely the opposite effect on the allocation of resources than saving out of current income. Instead of lowering its share of consumption in GDP, the associated consumer borrowing-and-spending binge increases its share, thus leaving less resources for capital investment.

We have undertaken this scrutiny of the macroeconomic essence of saving in order to make clear that from the macro perspective, saving out of current income sets the limits to capital investment. Therefore, America's protracted savings crisis implies a protracted investment crisis.

ASIAN SAVINGS GLUT OR AMERICAN CREDIT EXCESS?

As we have repeatedly stressed, the Federal Reserve luminaries are busy rewriting economics. What in most other countries would be regarded as malign imbalances needing correction are for American policymakers and economists an emblem of economic strength.

The most notorious case of this kind is the monstrous U.S. trade deficit. By definition, such a deficit implies that this country is spending more than it produces and earns. At all times in history, this has been regarded as something highly undesirable, particularly when the spending excess is overwhelmingly in consumption, as it is in the United States.

On March 10, 2005, then-Gov. Ben S. Bernanke revealed to the Virginia Association of Economics that this traditional explanation of a trade deficit is in the U.S. case completely misguided. This U.S. deficit, he explicated, does not derive from an American credit-and-spending glut, but from the emergence of a global saving glut heading toward the United States as a country that offers the most attractive assets in the world. In other words, this deficit is "made in Asia," not "made in the USA."

Explaining this, he starts with the truism that net capital inflows and the current account deficit essentially coincide. His next argument, then, is that the Asian trade surpluses reflect, by definition, an excess of domestic saving over domestic investment, while the U.S. trade deficit, also by definition, reflects an excess of domestic investment over domestic saving. Of necessity, capital inflows must make up for this shortfall. In this view, the United States is really doing the world a favor by absorbing its saving surplus.

First of all, nothing could be more evident than the U.S. credit excess. A look at the numbers as documented in the Fed's Flow of Funds Accounts reveals a virtual trebling of credit growth since 1995. Moreover, this credit explosion materialized against the backdrop of collapsing national and personal saving. To put it point-blank: The Greenspan Fed has been practicing credit excess at a scale for which there is no parallel in history.

The next question to ask, of course, is how it came about. Was it induced by the capital inflows through unusual monetary looseness on the part of the Fed?

The first thing to take into account is that the United States operates a system of flexible exchange rates. This implies on the part of the Fed complete abstention from any interventions in the currency markets. This is most important to keep in mind, because under this exchange rate regime, international capital flows have diametrically different effects from what happens under a fixed-rate regime, because no money can move.

Now let us assume that due to the Asian saving glut, capital inflows have been flooding into the United States. What happens? For sure, the dollar soars. But what other effects does this involve, on U.S. liquidity, employment, incomes and profits?

None at all in the first case, because an economy with a flexible exchange rate is hermetically closed to money or liquidity inflows. Emphasis is on first case. Yet two things begin to impact the economy. Due to the soaring dollar, exports slow or decline, while imports surge.

Together, the two bring about a big and rising U.S. trade deficit, which for the Asians represents an equal export surplus. This export surplus actually makes the dollars available that the Asian investors want and need for their investments in the United States.

What other effects do the capital inflows have on the U.S. economy? To repeat: none. To repeat categorically: Under a system of flexible exchange rates, capital flows are deprived of any liquidity effects. They impact both economies exclusively through exchange rate effects. The currency of the capital-exporting country rises and that of the

capital-importing country declines. Imagine Asian currencies falling against the dollar because of their capital outflows.

But what happens to employment, incomes and profits in the United States? Here, too, the answer is directly nothing. But what hits them all with tremendous deflationary force over time is the huge and soaring U.S. trade deficit, pulling dollar for dollar out of domestic spending and income circulation.

If the capital inflows were the primary influence in creating the U.S. deficit, they would in this way have exerted a savage deflationary squeeze on the whole U.S. economy and its financial system. Considering the actual dimensions involved, the U.S. economy would now be in depression. Instead of a credit explosion, there would have been a credit implosion.

THE TRUE CAUSE

The idea of an Asian savings glut fueling the U.S. trade deficit is macroeconomic nonsense. This deficit and all the other imbalances in the U.S. economy have one obvious single cause. It is the cause that historically has caused trade deficits. This is extraordinary credit excess financing, mainly, consumption. It is totally different when the credit excess finances investment.

Over the five years since 2000, an overall U.S. credit expansion, financial and nonfinancial, by $11.2 trillion compares with nominal GDP growth of $2.6 trillion and real GDP growth of $1.3 trillion. That is, each dollar added to nominal GDP requires $4.30 be added to overall debt. In relation to real GDP growth, the debt ratio was 8.6:1.

And now for comparison, the credit-to-GDP ratio that prevailed over the first three postwar decades, the 1950–70s. Over these years, it took on average $1.40 or $1.45 for each $1 added to GDP.

Since the early 1980s, credit expansion in the United States has run increasingly in excess of economic activity. That is one big problem. The second is that the bubble-related borrowing-and-spending excesses have brought about major changes in the entire U.S. economy's real and financial situations.

The most profligate credit expansion in history had three outstanding outlets: *first*, consumer spending, mainly on housing and durables; *second*, imported manufactured goods; and *third*, financial speculation through carry trade.

IN SEARCH OF THE ULTIMATE CAUSE

Looking for causes, the snag is that most events are both cause and effect. The extremely poor employment and income growth in the U.S. economy has, of course, its cause or causes. At the same time, it acts in its turn as the cause of lower consumer spending. We keep looking for the general ultimate cause of all evils, like the trade deficit and the lack of employment and income growth.

In the U.S. case, the available statistical data leave no doubt as to the *ultimate cause of all evils*. It is the collapse of national and personal saving, implying that it absorbs a rising share in overall spending and GDP growth. What American policymakers and economists flatly refuse to see is that this must essentially crowd out capital investment and net exports. They live in the illusion that rising consumption must stimulate investment.

Look for opposite experience in countries of the past or present with sustained vigorous but investment-led economic growth. The outstanding cases are Germany and Japan in the past and China in the present. Common to them all have been, respectively, high rates of saving and investment and (by the way) high export surpluses.

This pattern corresponds to ample historical experience and economic logic. The thing to see is that a consumption bubble is no substitute for grossly lacking capital formation. It creates artificial, unsustainable growth from the demand side in the short run, but it weakens the supply side through falling savings and lagging capital formation in the long run.

In the lectures at the London School of Economics in 1931 that made him famous among English-speaking economists, Friedrich Hayek of the Austrian School described in detail how excessive consumer credit and a

corresponding fall in saving brings about a "shortening of the production process" or a "shrinkage of the capitalistic production structure."

His point was that an increasing share of consumption in GDP must inevitably diminish the share of capital investment, and thus lead to a contraction of the industries producing goods for this purpose.

Basically, this suggests that in such an economy, capital-intensive employment increasingly gives way to employment using very little or no capital. In the United States, all of the job destruction is in the capital-intensive manufacturing sector, particularly in the capital goods sector, while all of the job creation is in trade and services, using very little or no capital.

Hayek's conclusion was that shrinking business investment, then, leads to recession. At the time, he described this as the regular feature of the business cycle, leading to regular recession. Perhaps the plunge of business investment in the United States in 2001–02 was still largely cyclical, but the following bubble policies pursued by the Greenspan Fed have fatally accelerated and cemented this structural downgrading of the U.S. economy.

In the late 1990s, the equity bubble disproportionately boosted consumer spending. Since 2000, the housing bubble has. In the late 1990s, the pattern started as a marginal structural change. The housing bubble and the associated stupendous consumer borrowing binge, lasting five years now, have turned it into a major shift in the U.S. economy's structure. The table on page 5 shows the dramatic changes in the distribution of profits between different sectors of the economy that have resulted from this structural change.

THE EVIL ROLE OF THE TRADE DEFICIT

In this restructuring of the U.S. economy, the rapidly growing U.S. trade deficit has played a crucial role in destroying millions of high-paying manufacturing jobs. Surely, productivity growth also contributes; but it should be clear that the annual diversion of now more than $700 billion in domestic spending on goods to foreign producers, as reflected in the trade deficit, is a major job destroyer in U.S. manufacturing.

In the absence of countermeasures, this economic and financial drag would long ago have driven the U.S. economy into recession. In order to prevent this, a permanent overexpansionary monetary posture is needed to generate alternative demand.

A central bank may be able to create demand, but it has little or no influence on the kind of demand that actually responds. An obvious problem in the United States is that consumers are highly responsive to the offering of credit, while businesses are highly unresponsive in borrowing specifically for capital investment.

While aggregate consumer spending has persistently risen, an increasing part has been diverted to foreign producers. As a result, domestic spending growth is increasingly directed toward services, mostly low-paid services.

It seems to us an obliging conclusion that this restructuring of the U.S. economy toward lower-paid jobs essentially becomes cumulative. Facing cheap Asian competition with no end in sight, American producers restrain the growth of their capital stock. The net results are declining export capacity and a growing U.S. trade deficit. On the other hand, the loss of demand through the trade deficit keeps dragging U.S. monetary policy into its overly loose posture, to maintain overall domestic demand.

Of course, manufacturers in Europe face the exact same problem, but they do not have the consumer spending excesses, which through their boost to the U.S. trade deficit accelerate the erosion of U.S. manufacturing.

The American Pollyannas completely fail to see the resulting pernicious shift in the U.S. economy's output and employment structure, absurdly ascribing it to productivity growth. Manufacturing is the great loser; the service industry is the winner.

The biggest winner of all, though, is Wall Street and the asset markets. That is because the same monetary looseness that tries to offset the trade deficit's drag on the economy serves wonderfully to inflate asset prices. These, in turn, serve wonderfully to inflate consumption, at the expense of saving and investment. The American

consensus regards this as a virtuous circle. With our eyes on the detrimental structural changes in the U.S. economy's production and employment, we regard it as a vicious circle impoverishing the nation.

At the same time, we observe generally flat refusal to accept painful measures to curb this process of impoverishment. It would require higher interest rates and taxes to slow overall spending growth relative to the economy's potential rate of output growth. As nobody in America is willing to accept this "sacrifice," they pretend that the trade deficit does not matter.

CONCLUSIONS:

It has yet to be generally realized that the most lavish fiscal and monetary policies in the United States over the past few years have completely failed to restore economic growth with the necessary dynamics to become self-sustaining. Without the artificial pull from the housing bubble, the economy will relapse into recession.

The central policy failure consists in the accelerating erosion of the industrial base, accruing from the coincidence of a huge and soaring trade deficit and sluggish fixed investment. The production of durables is the only part of manufacturing that has kept growing, and this with the housing bubble and massive auto promotion.

Inflation-adjusted U.S. interest rates still appear pretty low. But the relative rise of the Fed's short-term rate has been pulling the rug from under the carry trade, financed in dollars. Though it has partly shifted to low-interest-rate currencies, tightening carry trade is raising long-term rates. Being convinced of the U.S. economy's inherent strength, this is perhaps what the Fed wants. We see a house of cards.

For us it is a token that consumer spending in the United States is in for a sharp slowdown in the course of the current year. During 2005, private households lost the big support from the tax cuts, and this year they will further lose most of the support from the housing and mortgage refinancing bubble. On the other hand, their growth of real disposable income has plunged to an unprecedented low of little over 1%.

Retail sales, as a matter of fact, have been virtually stagnant in nominal terms between June and November. Both in November and December, they benefited more from amazingly low inflation rates than from higher spending.

For us, the true conundrum is that all the rate hikes have completely failed to slow the rampant credit expansion. We have no other explanation than a higher and growing share of Ponzi financing.

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